No. 21,671

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

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PACIFIC GRAINS, INC., AN OREGON CORPORATION,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

ON PETITION FOR REVIEW OF THE DECISION OF
THE TAX COURT OF THE UNITED STATES

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# BRIEF FOR THE RESPONDENT

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RICHARD C. PUGH,
Acting Assistant Attorney General.

MEYER ROTHWACKS,
HOWARD J. FELDMAN,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

# I N D E X



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## OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 75-83) are not officially reported.

## JURISDICTION

This petition for review (I-R. 85-86) involves federal income taxes for the fiscal years ending January 31, 1963, and January 31, 1964. On May 18, 1965, the Commissioner of Internal Revenue mailed to the taxpayer a notice of deficiency, asserting deficiencies in income tax in the amount of $5,850 for the fiscal year ending January 31, 1963, and in the amount of $12,408.06 for the fiscal year ending January 31, 1964. (I-R. 21-24.) Within ninety days thereafter, or on August 6, 1965, the taxpayer filed a petition

with the Tax Court for a redetermination of those deficiencies und the provisions of Section 6213 of the Internal Revenue Code of 195 (I-R. 1-2.) The decision of the Tax Court was entered January 13, 1967. (I-R. 84.) The case is brought to this Court by a petition for review filed January 31, 1967 (I-R. 85-86), within the three-month period prescribed in Section 7483 of the Internal Revenue Co of 1954. Jurisdiction is conferred on this Court by Section 7482 that Code.

## QUESTION PRESENTED

Whether there is substantial evidence to support the Tax Cour finding that reasonable compensation deductible by taxpayer for salary and bonus payments made to its sole shareholder and preside was $30,000 for each of the fiscal years ending January 31, 1963, and January 31, 1964.

## STATUTES AND REGULATIONS INVOLVED

The statutes and Regulations involved are set out in the Appe infra.

## STATEMENT

The facts as stipulated (I-R. 15-20) and as found by the Tax (I-R. 76-79) may be summarized as follows:

Taxpayer, Pacific Grains, Inc., was organized under the laws Oregon on February 19, 1955, and its principal office is in Rickre Oregon. Taxpayer filed federal income tax returns for the fiscal years ended January 31, 1963 and 1964, with the District Director of Internal Revenue, Portland, Oregon. Robert R. Rodgers presentl

owns all of the taxpayer's outstanding shares of common stock (2,000 shares). During the years here involved taxpayer was engaged in the business of purchase, sale, storage, distribution and brokerage of grain and grass seed. (I-R. 76.)

Robert R. Rodgers formed the taxpayer-corporation together with Wayne R. Giesy, with Rodgers serving as president and treasurer and Giesy serving as vice-president. Taxpayer's principal asset originally was a grain elevator with a capacity of approximately 300,000 bushels. Later in 1955, taxpayer built another grain elevator at Suver, Oregon, with a capacity of 50,000 bushels, and in 1960 taxpayer leased a grain elevator at Dallas, Oregon, with a capacity of 50,000 bushels. In February, 1959, Giesy sold his stock in taxpayer to Rodgers, who agreed to assume all of the liabilities which had been incurred by the parties in their venture. Rodgers then took over the duties previously performed by Giesy. (I-R. 76-77.)

In 1961, the Federal Government initiated the soil bank and diversified feed-grain programs and as a result the production acreage in this area was reduced. To offset the loss of grain storage income, taxpayer became active in trading grass seed on a world-wide basis. (I-R. 77.)

Taxpayer's over-all investment in grain storage facilities in 1963 and 1964 was approximately $260,000 and $340,000, respectively. Taxpayer's total sales for the fiscal years ending January 31, 1962 through 1964, were $1,709,364.73, $1,724,318.86 and $2,289,001.45, respectively. During the years here involved taxpayer's income from

grain storage and cleaning represented approximately 15 percent of its gross income, and the remaining 85 percent was earned through i brokerage operations. (I-R. 77.)

During the years here involved Robert R. Rodgers was president and treasurer of the taxpayer, Thelma M. Rodgers was the secretary, and William H. Kinsey was assistant secretary. The same three individuals also served as the directors of the corporation during this period. (I-R. 77.)

Taxpayer paid a base salary of $25,200 to Robert Rodgers in each of the fiscal years ending January 31, 1963 and 1964. At a special meeting of taxpayer's board of directors held on December 2 1962, a bonus payment to Rodgers was authorized for the fiscal year ending January 31, 1963, in an amount not less than $15,000 nor mor than $20,000. At a special meeting of the board of directors held on December 27, 1963, a bonus payment to Rodgers was authorized for the fiscal year ending January 31, 1964, in the amount of $30,000. (I-R. 77-78.) The following schedule shows taxpayer's taxable inco and the base salary and bonus payments made to Rodgers in the fisca years ended January 31, 1960 through 1964 (I-R. 78):

| Fiscal Year Ending 1/31 | Corporate Taxable Income | Base Salary | Bonus | Total |
|---|---|---|---|---|
| 1960 | $ 3,642.79 | $12,000 | $10,000 | $22,000 |
| 1961 | (16,838.48) | 22,000 | None | 22,000 |
| 1962 | 24,681.67 | 24,000 | 5,000 | 29,000 |
| 1963 | 26,362.78 | 25,200 | 16,050 | 41,250 |
| 1964 | 34,630.25 | 25,200 | 30,000 | 55,200 |

Taxpayer's other principal employees (on the basis of salary) received the following compensation in the fiscal years ended January 31, 1963 and 1964 (I-R. 78):

| | F/Y 1/31/63 | | F/Y 1/31/64 | |
|---|---|---|---|---|
| Name | Wages | Bonus | Wages | Bonus |
| Neil Evenson | $9,828.75 | $2,500 | $14,828.75 | $5,000 |
| Joel Miller | 5,952.45 | 500 | 6,452.45 | 1,000 |
| J.D. Montgomery | | 500 | | 1,000 |

The balance sheets included in taxpayer's federal income tax returns for its fiscal years ended January 31, 1963 and 1964, indicate an earned surplus and undivided profits as of January 31, 1963 and 1964, in the respective amounts of $75,730.26 and $99,904.91. No dividends have been paid by taxpayer since its organization. (I-R. 78.)

Taxpayer claimed a deduction for compensation paid to Rodgers in the total amount of $41,250 for the fiscal year ended January 31, 1963, and in the total amount of $55,200 for the fiscal year ended January 31, 1964. The Commissioner, in his statutory notice of deficiency, disallowed the amount claimed by taxpayer as a deduction for compensation to Rodgers in excess of $30,000 in each of the fiscal years ended January 31, 1963 and 1964. (I-R. 78-79.) The Tax Court approved of the Commissioner's determinations and found that reasonable compensation for each year was $30,000. (I-R. 83.)

## SUMMARY OF ARGUMENT

What is reasonable compensation is essentially a factual question to be determined by the peculiar circumstances in each case in accordance with certain generally accepted considerations and the overriding

principles set forth in Section 162(a)(1) of the Internal Revenue Code of 1954 and the Treasury Regulations promulgated thereunder. The Tax Court was the trier of facts. The circumstances surrounding the so-called "bonus" payments here in question -- i.e., those made to a corporation's sole shareholder-president who also controlled its board of directors under resolutions from the board originating late in each of the years in question when no dividends had been declared since the corporation's inception -- as found by the Tax Court, ran afoul of the above-mentioned considerations and principle The facts support the Tax Court's conclusion that reasonable compensation for each of the years in question was $30,000.

The question of the weight of the evidence and the credibility of the testimony introduced was for the trier of the facts. Since the taxpayer has not shown the ultimate findings below to be clearly erroneous, and plainly has not sustained its burden of proving the claimed salary amount to be correct, the Tax Court's decision should be affirmed.

## ARGUMENT

### THERE IS SUBSTANTIAL EVIDENCE TO SUPPORT THE TAX COURT'S FINDING THAT REASONABLE COMPENSATION DEDUCTIBLE BY TAXPAYER FOR SALARY AND BONUS PAYMENTS MADE TO ITS SOLE SHAREHOLDER AND PRESIDENT WAS $30,000 FOR EACH OF THE FISCAL YEARS ENDING JANUARY 31, 1963, AND JANUARY 31, 1964

The sole issue on this review is whether there is substantial evidence to support the Tax Court's finding that reasonable compensation deductible by taxpayer for salary and bonuses paid to Robert R. Rodgers, its president and sole shareholder, was $30,000 for each of

the fiscal years ending January 31, 1963, and January 31, 1964. This, of course, is a pure question of fact, and the determinations of the Tax Court, which had an opportunity to pass on the credibility of the witnesses, the weight of the evidence, and the inferences to be drawn therefrom, are conclusive if supported by substantial evidence. Helvering v. Nat. Grocery Co., 304 U.S. 282, 294-295; Hoffman Radio Corp. v. Commissioner, 177 F. 2d 264, 266 (C.A. 9th); Kennedy Name Plate Co. v. Commissioner, 170 F. 2d 196 (C.A. 9th); E. Wagner & Son v. Commissioner, 93 F. 2d 816, 818 (C.A. 9th); Perlmutter v. Commissioner, 373 F. 2d 45, 47 (C.A. 10th); Golden Construction Co. v. Commissioner, 228 F. 2d 637, 638 (C.A. 10th); Standard Asbestos Mfg. & Insulating Co. v. Commissioner, 276 F. 2d 289 (C.A. 8th), certiorari denied, 364 U.S. 826. We submit that there is ample evidence in the record to sustain the findings of the Tax Court and its decision should be affirmed.

Section 162(a)(1) of the Internal Revenue Code of 1954, Appendix, infra, permits a deduction for a reasonable allowance for salaries or other compensation for personal services actually rendered. The Regulations interpreting this Code section provide that bonuses will constitute allowable deductions provided that such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. Treasury Regulations on Income Tax (1954 Code), Section 1.162-9, Appendix, infra. Pursuant to these provisions, the Commissioner reduced the allowable deduction for compensation paid to Rodgers from $41,250 (consisting of a salary of $25,200 and a bonus of $16,050) to $30,000 for the fiscal year

January 31, 1963, and from $55,200 (consisting of a salary of $25,2 and a bonus of $30,000) to $30,000 for the fiscal year ending January 31, 1964. (I-R. 22-23, 78.)

Many factors must be examined in determining whether compensation paid to an individual is reasonable and may be deducted by a corporation in its entirety. A list of factors, by no means all-inclusive, was set out in Mayson Mfg. Co. v. Commissioner, 178 F. 2 115, 119 (C.A. 6th):

> * * * the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

The situation must be considered as a whole, with no single factor decisive. Mayson Mfg. Co. v. Commissioner, supra, p. 119. In othe words, the circumstances of each case must be carefully examined to see whether deductions for compensation are reasonable. Perlmutter v. Commissioner, supra, p. 47; Golden Construction Co. v. Commissio supra, p. 638.

Here Rodgers, the payee, was the sole shareholder of taxpayer, its president and treasurer, and a member of its board of directors for both of the years in question. (I-R. 76-77.) In fact, Rodgers and his wife, who was secretary of the corporation and a board member, at all times controlled two out of the three board of directors' seats. (I-R. 77.) Only Rodgers and his wife were

present when the board awarded bonuses to Rodgers for each year here at issue. (I-R. 64, 68.) Special scrutiny must be given to compensation paid by corporations whose stock is closely held because of the lack of arm's length bargaining, which in turn may result in a distribution of profits under the guise of salary or bonus payments. Hampton Corp. v. Commissioner, decided June 1, 1964 (P-H Memo T.C., par. 64,150), affirmed per curiam June 11, 1965 (C.A. 9th) (16 A.F.T.R. 2d 5265); Perlmutter v. Commissioner, supra, p. 47; Logan Lumber Co. v. Commissioner, 365 F. 2d 846, 851 (C.A. 5th); Heil Beauty Supplies v. Commissioner, 199 F. 2d 193, 194 (C.A. 8th); Oswald v. Commissioner, 185 F. 2d 6, 9 (C.A. 7th); Commercial Iron Works v. Commissioner, 166 F. 2d 221, 224 (C.A. 5th). Here we have the classic example of a closely held corporation -- Rodgers is the sole shareholder and controls the board of directors -- and the resolutions of the board of directors are, for all intents and purposes, expressions of his will. See Golden Construction Co. v. Commissioner, supra, p. 638; Miles-Conley Co. v. Commissioner, 173 F. 2d 958 (C.A. 4th); Ecco High Frequency Corp. v. Commissioner, 167 F. 2d 583 (C.A. 2d).

The resolutions granting additional compensation to Rodgers were promulgated by the board of directors near the end of the year, when corporate profits could be approximated. (I-R. 64, 68, 81.) In fact, the bonus resolution adopted by the board of directors on December 28, 1962, for the fiscal year ending January 31, 1963, which granted a bonus "not less than $15,000 nor more than $20,000, the exact amount of such bonus to be left to the discretion of the president" (I-R. 64), appears to be specifically geared to the final profit generated by

taxpayer. This is a clear example of Rodgers' ability to adjust his bonus to the profit of the corporation at the end of the year and reduce corporate income by a salary deduction, rather than distribute a nondeductible dividend distribution. 1/

Taxpayer's practice of delaying declaration of bonuses until late in the fiscal year is especially subject to scrutiny when contrasted with the fact that no dividends were paid for the two years in question and, in fact, no dividends had been paid by taxpayer since its incorporation. (I-R. 81.) Yet earned surplus and undivided profits shown on balance sheets attached to taxpayer's income tax returns were $75,730.26 for the fiscal year ending January 31, 1963, and $99,904.91 for the fiscal year ending January 31, 1964. (I-R. 78.) Lack of dividends in the face of available profits and increased salaries has been cited as a key factor in denying unreasonable compensation deductions by a corporation. See Hampton Corp. v. Commissioner, supra; E. Wagner & Son v. Commissioner, supra, p. 819; Perlmutter v. Commissioner, supra; Miles-Conley v. Commissioner, supra, p. 960; Commercial Iron Works v. Commissioner, supra, p. 224.

It is also significant to note that Rodgers' abilities and his duties with respect to the trading business were well known to taxpayer when its board of directors set his salary for the fiscal year commencing February 1, 1962, at $2,100 per month, or $25,200 per year. (I-R. 59.) See Heil Beauty Supplies v. Commissioner, supra, p. 194; Builders Steel Co. v. Commissioner, 197 F. 2d 263 (C.A. 8th); Wenatchee

1/ In fact, taxpayer admits (Br. 24-25) that it deducted increased amounts for salaries to bring corporate profits to approximately the surtax exemption level.

Bottling Works v. Henricksen, 31 F. Supp. 763 (W.D. Wash.). Taxpayer had become active in the trading business in 1961, and the $29,000 paid to Rodgers for the fiscal year ending January 31, 1962, consisting of $24,000 in salary and $5,000 bonus would appear to reflect all increased compensation due to him for his services with respect to the trading aspects of the business. 2/ (I-R. 77, 80.) The record does not show an increase in Rodgers' duties and responsibilities commensurate with the sudden increase in compensation by 40 percent and 90 percent for the two years here at issue. 3/ (I-R. 80.) See Hoffman Radio Corp. v. Commissioner, supra, p. 266; E.B. & A.C. Whiting Co. v. Commissioner, 10 T.C. 102, 115.

Taxpayer notes (Br. 43-46) that it maintained a uniformly high return on its investment despite its deduction for compensation paid to Rodgers. This is only one factor in determining reasonable compensation. In fact, a comparison of Rodgers' compensation with other key corporate figures leads to the conclusion that such payments were excessive. For example, Rodgers' compensation was approximately 156 percent and approximately 159 159 percent of the taxable income for the fiscal years ending January 31, 1963, and January 31, 1964, respectively. (I-R. 78.) Stated differently, Rodgers' compensation

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2/ The $30,000 figure set by the Tax Court therefore gives Rodgers an approximate bonus of $5,000 for each year, consistent with the prior year's action by the corporation.

3/ Taxpayer argues (Br. 21-22, 25) that the Commissioner never complained about the increase of $7,000 in Rodgers' compensation to $29,000 for the fiscal year ending January 31, 1962, but, as pointed out above, Rodgers rendered additional services in the trading aspect of the business in that year for the first time, which merited the salary increase. Consistently, the Commissioner allowed approximately the same compensation for the next two fiscal years when the same services were being performed.

was 61 percent of taxpayer's income before the deduction of salaries for each of the years. (I-R. 78.) Moreover, his compensation was approximately 17 percent of the gross profit for the fiscal year ending January 31, 1963 (I-R. 25), and approximately 18 percent of the gross profit for the fiscal year ending January 31, 1964 (I-R. 34). Rodgers' compensation was also about twice the wages and bonuses paid to the three other principal employees for these two years (I-R. 78), and almost equal to taxpayer's total payroll for eight full-time and sixteen part-time employees for these years (I-R. 19, 25, 34). To summarize, the over-all picture shows increasing profits matched by higher salaries -- an indication of the drawing off of corporate profits to controlling shareholders. Miles-Conley v. Commissioner, supra.

Taxpayer argues (Br. 28-34) that the additional compensation paid to Rodgers is deductible as payment for prior services. However, nothing in the resolutions of the board of directors voting the increased compensation indicates that it was for anything except services performed in the year of payment. (I-R. 64, 68, 81-82.) See Perlmutter v. Commissioner, supra, p. 48; Pinkham Med. Co. v. Commissioner, 128 F. 2d 986 (C.A. 1st); Standard Asbestos Mfg. & Insulating Co. v. Commissioner, 276 F. 2d 289, 293 (C.A. 8th), certiorari denied, 364 U.S. 826; E.B. & A.C. Whiting Co. v. Commissioner, supra, p. 117. But taxpayer sidesteps this problem (Br. 12, 28) by lifting language from the Treasury Regulations on Income Tax (1954 Code, Section 1.404(a)-1, Appendix, infra--interpretin Section 404 of the Internal Revenue Code, Appendix, infra, dealing with

contributions to an employee's trust or annuity plan and compensation under a deferred payment plan--to devise a total aggregate compensation theory to justify its excessive deductions. Under this theory, it would be allowed to deduct at the end of any year an amount, in addition to the reasonable compensation payable for that year, which would bring a payee's total compensation for all years to a maximum aggregate reasonable compensation. But taxpayer's reliance on these Regulations is misplaced. Although contributions to such plans must be considered together with compensation for services to determine whether the total is reasonable for a particular year under Section 162 of the 1954 Code, that section and its interpretive Regulations contain no corresponding provisions to update all past compensation. 4/ Contributions under these plans for past services present a unique situation which may not be extended to additional compensation for past services. 5/

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4/ Ernest Burwell, Inc. v. United States, 113 F. Supp. 26, 30 (W.D. S. Car.), and Jewell Ridge Coal Sales Co. v. Commissioner, decided February 14, 1957 (P-H Memo T.C. par. 57,030), do not support taxpayer's claim (Br. 28) that the language of the Regulations under Section 404, dealing with aggregate deductions, is applicable to Section 162.

5/ This is not to say that a corporation may not reward its employees for past services. See Lucas v. Ox Fibre Brush Co., 281 U.S. 111. But, as a first step, such compensation must be earmarked for past services, presumably by a board resolution. See Perlmutter v. Commissioner, supra, p. 48; Pinkham Med. Co. v. Commissioner, supra; Standard Asbestos Mfg. & Insulating Co. v. Commissioner, supra, p. 293; E.B. & A.C. Whiting Co. v. Commissioner, supra, p. 117. As noted above, taxpayer did not so earmark its additional payments. Next, it must be shown that the compensation for these past services was reasonable. Lucas v. Ox Fibre Brush Co., supra. Taxpayer's attempt to prove the latter without having specified the compensation as being for past services in the year of deduction appears to be only a tardy response to the Commissioner's disallowance of portions of the bonuses for the years in question as unreasonable.

Taxpayer seeks justification (Br. 21-27) in this total aggregat compensation theory in an analysis of the corporate tax structure which permits a surtax exemption for the first $25,000 of taxable income each year. Taxpayer appears (Br. 24-25) to devise a formula which would entitle it to deduct from net profit, as additional compensation, amounts which would reduce taxable income to the surta level, i.e., $25,000. There is no doubt that taxpayer is entitled t all legitimate deductions to reduce its income to the lowest possibl point for tax purposes. But it cannot carry over or save deductions from prior years to reduce income from later, more profitable years to the surtax level.

Next taxpayer compares (Br. 29-34) the average compensation it paid to Rodgers over a nine-year period, or $22,860, with the $26,05 average yearly compensation received from his prior employer, Derry Warehouse Company, and concludes that the bonus payments for the yea in question merely brought his average salary up to the amounts he earned from prior employment. Initially, it is important to point out that salaries received from Derry Warehouse are of little use fo comparative purposes since his services there were not comparable to his duties with taxpayer. (I-R. 82.) But, more important, taxpayer conveniently overlooks the other large benefit accruing to Rodgers due to his special relationship with taxpayer: He built up his equity in the corporation, first as a 50 percent shareholder and later as sole shareholder, and thus became the owner of the under-

lying assets generated by his and others' services. 6/ And taxpayer'

6/ He could, at any time, liquidate the corporation, or, better yet, declare a dividend from retained earnings to receive his "deferred

argument (Br. 29-30) that it could not have enticed Rodgers away from his prior employer in an arm's length transaction without assuring him that low compensation in the company's formative years would be made up in the future so as to average at least $26,050 is inconsistent with the fact that taxpayer was formed by Rodgers and Giesy in 1955 (I-R. 76); there was no enticing of a new employee by a guaranteed average annual salary, but merely the embarkation by Rodgers and Giesy upon a new corporate enterprise with the risks attendant thereto.

Taxpayer next argues (Br. 35-38) that the Tax Court was bound to accept the testimony of its witnesses when the Commissioner offered no rebuttal testimony. However, the rule in this Court is just the opposite -- the lower court is not bound to accept any uncontradicted testimony, but may examine all testimony in the light of the demeanor of the witnesses and the substance of their testimony, as well as all other facts in the record. Scates v. Isthmian Lines, 319 F. 2d 798, 799; Ramos v. Matson Nav. Co., 316 F. 2d 128, 132; Factor v. Commissioner, 281 F. 2d 100, 111, certiorari denied, 364 U.S. 933; N.L.R.B. v. Howell Chevrolet Co., 204 F. 2d 79, affirmed without discussion on this point, 346 U.S. 482; 7/ Ng Yip Yee v. Barber, 267 F.2d 206, 209; Quon v. Niagara Fire Ins. Co. of N.Y., 190 F. 2d 257, 259;

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7/ This Court there stated that the argument that it is well settled law that where a witness' testimony is not contradicted a trier of fact has no right to refuse it (p. 86)--

> * * * is an ancient fallacy which somehow persists despite the courts' numerous rulings to the contrary. It overlooks the significance of the carriage, behavior, bearing, manner and appearance of a witness, -- his demeanor, -- when his testimony is given orally in the presence of the trier of facts.

Mitsugi Nishikawa v. Dulles, 235 F. 2d 135, 140, reversed, 356 U.S. 129; Lau Ah Yew v. Dulles, 257 F. 2d 744. This is exactly what the Tax Court did (R. 82):

> We have considered the testimony of petitioner's witnesses as to compensation paid for comparable services in comparable businesses. We are not bound by the valuation opinions of these witnesses, even though uncontradicted. Golden Construction Co. v. Commissioner, 228 F. 2d 637 (C.A. 10, 1955), affirming a Memorandum Opinion of this Court. Moreover, much of this testimony consisted of conclusions which were of limited assistance to this Court. At any rate, in the light of the facts of record, this testimony did not prove helpful in determining the reasonableness of the compensation paid to Rodgers during the fiscal year before us.

As to particular witnesses, David Lees at no time revealed his compensation or the gross or net profit of his corporation, although he stated that all were comparable to the facts presented in the instant case. Moreover, it is unclear what year he was using for comparative purposes, a factor of importance because of the additional increase in compensation for the fiscal year ending January 31, 1964. 8/ (II-R. 46-48.) The testimony of William Wiley is similarly of no value since he was engaged in a different type of trading and did not disclose his gross profits for comparative purposes, and, most important, he operated a sole proprietorship, which would render useless any comparison of salary with that of a corporate employee. (II-R. 55, 56.) Harold Brevig's testimony as to average rate of return of his other clients was incomplete for purposes of

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8/ The Tax Court was well within its power in refusing to recognize the witness David Lees as an expert on salaries paid in this type of business and, under the circumstances, correctly limited his testimony to the best evidence he could offer -- his own compensation. See 4A Mertens, Law of Federal Income Taxation (Rev.), Section 25.83.

any comparison (II-R. 34-35), and his comparison of other companies was completely irrelevant since they were substantially larger than taxpayer and engaged in different businesses. Brevig also lacked the specific knowledge as to these companies necessary for comparative purposes. (II-R. 32-34.) Finally, Rodgers' testimony may be considered only in the light of its self-serving nature. (II-R. 14-27.)

## CONCLUSION

In the final analysis, the examination of many factors indicates that the Tax Court correctly upheld the Commissioner's determination that reasonable compensation for each of the two years in question was $30,000. As stated by the court (R. 83), "We have considered all of the evidence and all of the petitioner's arguments and we do not believe that petitioner has met its burden of proof." The trial court's purely factual determination, not being clearly erroneous, should be affirmed.

Respectfully submitted,

RICHARD C. PUGH,
Acting Assistant Attorney General.

MEYER ROTHWACKS,
HOWARD J. FELDMAN,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

AUGUST, 1967.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _____ day of July, 1967.

HOWARD J. FELDMAN
Attorney

APPENDIX

Internal Revenue Code of 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

* * * * *

(26 U.S.C. 1964 ed., Sec. 162.)

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) [as amended by Sec. 24(a), Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] General Rule.--If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

* * * * *

(26 U.S.C. 1964 ed., Sec. 404.)

Treasury Regulations on Income Tax (1954 Code):

§1.162-7. Compensation for personal services.

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances.

compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder.

(26 C.F.R., Sec. 1.162-7.)

§1.162-9. Bonuses to employees.

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

(26 C.F.R., Sec. 1.162-9.)

§1.404(a)-1. Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

* * * * *

(b) In order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a). Contributions may therefore be deducted under section 404(a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered. In no case is a deduction allowable under section 404(a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among

the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. A contribution under a plan which is primarily for the benefit of shareholders of the employer is not deductible. Such a contribution may constitute a dividend within the meaning of section 316. See also §§1.162-6 and 1.162-8. In addition to the limitations referred to above, deductions under section 404(a) are also subject to further conditions and limitations particularly provided therein.

* * * * *

(26 C.F.R., Sec. 1.404(a)-1.)

NO. 21671

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

IFIC GRAINS, INC.,

Appellant,

v.

MISSIONER OF INTERNAL
ENUE,

Appellee.

# APPELLANT's REPLY BRIEF

TZ, SOUTHER, SPAULDING,
KINSEY & WILLIAMSON
.iam H. Kinsey
hen B. Hill
.2th Floor Standard Plaza
Portland, Oregon 97204

rneys for Appellant



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No. 21671

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APPELLANT'S REPLY BRIEF

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ARGUMENT

*THE DECISION OF THE TAX COURT IS CLEARLY ERRONEOUS EVEN WITHOUT TAKING INTO ACCOUNT UNDERPAYMENT FOR PRIOR YEARS*

Although the Commissioner frames the issue in terms of "... ther there is substantial evidence to support the Tax Court's ding that reasonable compensation deductible by taxpayer for ary and bonuses paid to Robert R. Rodgers, its president and e shareholder, was $30,000 for each of the fiscal years ending uary 31, 1963 and January 31, 1964" (Br 6), only two sentences the Commissioner's brief purport to explain or justify ection of the $30,000 as the maximum allowable compensation uction. These two sentences read as follows (Br 11):

"Taxpayer had become active in the trading business in 1961, and the $29,000 paid to Rodgers for the fiscal year ending January 31, 1962, consisting of $24,000 in salary and $5,000 bonus would appear to reflect all increased compensation due to him for his services with respect to the trading aspects of the business. 2/ (I.R. 77, 80.) The Record does not show an increase in Rodgers' duties and responsibilities commensurate with the sudden increase in compensation by 40 percent and 90 percent for the two years here at issue. 3/"

ote 3/ to the above quotation relates that the $30,000
mination represents allowance of approximately the same
nsation for the fiscal years ended January 31, 1963 and
as the $29,000 paid Rodgers for the fiscal year ended
ry 31, 1962.

The above reviewed portion of the Commissioner's brief makes ear that substantiation of $30,000 as the maximum allowable nsation for the fiscal years ended January 31, 1963 and 1964 unded upon the following dual propositions:

(1) The $29,000 paid Rodgers for the year ended January 31, 1962 reflected all compensation due him for his services on behalf of Petitioner, including his duties as a trader, this being the first year of extensive trading activities conducted by Rodgers.

(2) Any substantial increase in compensation for years subsequent to the fiscal year ended January 31, 1962 is unreasonable unless the increase is supported by a commensurate increase in duties and responsibilities.

re of either proposition destroys the basis for the Com-
oner's $30,000 determination and renders clearly erroneous
ax Court's decision sustaining such determination. Failure
ther proposition leaves the Commissioner and the Tax Court
ut any affirmative evidence to suppprt their determination
$30,000 was the maximum allowable compensation deduction

the fiscal years ending January 31, 1963 and January 31, 1964.

No evidence having been presented by the Commissioner, position (1) is a pure inference drawn from the mere fact that itioner paid Rodgers $29,000 for the fiscal year ended uary 31, 1962. Whether or not there may be fact situations ch justify the inference that payment of specified compensation a controlling stockholder for a given year establishes such unt as the maximum level of reasonable compensation for the e of services performed during the year, the inference is pplicable to Petitioner's fiscal year ended January 31, 1962. inference should not conflict with common sense. The fiscal r ended January 31, 1962 was the year of transition when Rodgers menced extensive trading operations to compensate for the drop warehousing and the grain storage business. Financial success a new venture may be luck rather than skill. It is sensible wait and see whether the success is repeated in subsequent rs before fully evaluating the services through increased pensation. Also, the $7,000 increase given Rodgers for the cal year ended January 31, 1962 was the precise sum needed to ng Petitioner's taxable income within the $25,000 surtax exemption. s negates any inference that $7,000 represented a premeditated ing of the maximum increase Rodgers merited because of the ed duties resulting from the trading aspects of the business.

Proposition (2), likewise necessary to suppprt the Com- sioner's $30,000 determination, assumes that increased duties

responsibilities are the only justifications for additional pensation.[1] This is clearly wrong. Increased productivity the performance of existing duties and responsibilities is ally deserving of monetary reward. Here, 85 percent of itioner's gross income (R 17, Stip. para. 6) and practically of the net income (Tr. 17-8, 39) was derived from trading ivities conducted by Rodgers. As stipulated, "... a serious or in judgment would have been financially disastrous" (R 18, p. para. 8). Thus, there was a direct relationship between efforts of Rodgers and the financial well being of Petitioner.

Not only did Rodgers avert financial disaster, but Rodgers' ding activities during the two years at issue substantially reased Petitioner's net income over that earned for the fiscal r ended January 31, 1962, the first year of trading. Having oneously assumed that additional compensation could be justified y by increased duties and responsibilities, the Tax Court did consider whether Rodgers' increased productivity during the ond and third years of trading warranted greater compensation n during the first year. When increased productivity of Rodgers the performance of existing duties and responsibilities is ognized as a justification for additional compensation,

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1 Contrary to the assertion of both the Commissioner the Tax Court, the work and duties of Rodgers did increase. dollar volume of sales for the fiscal year ended January 31, 4 had increased by thirty-four percent over the dollar volume sales for the fiscal year ended January 31, 1962 (R 18, Stip. a. 9). Most of such increase coming from trading by Mr. Rodgers grass seed on a world-wide basis (R 18, Stip. para. 8).

tation of the increase to $1,000 is clearly erroneous.[2]

A whopping fifteen percent return on invested capital pital plus retained earnings) was realized by Petitioner even er payment of the compensation alleged to be unreasonable. capital is liberally compensated, how can payment for ser- s be unreasonable? The Commissioner does not deny that tioner had a high return on invested capital, but attempts rush this aside with the observation that return on invested tal is merely one of many factors to be considered (Br. 11). ver, the other factors mentioned by the Commissioner have ificance only as to the inquiry of whether capital is being uately compensated.[3] Such factors are indirect indications hat the rate of return on invested capital has answered ctly.

Most of Defendant's argument belabors admitted facts such he lack of dividends paid by Petitioner, and declaration of bonuses at the end of the year after the profits were known. r explained by Defendant is exactly what bearing these facts

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2 It is absurd to presume that a man is of little or no tional value in his second and third year of work in a new ness than in his first year. This is especially true in ing where only through experience does one acquire a feel of market.

3 The Commissioner cites these various percentages for fiscal years here in dispute without any attempt to compare with comparable companies in the trading or grain storage ness or with petitioner's prior years. Without one of these eria for comparison these percentages are completely devoid eaning. That Rodgers' salary was 61 percent of Petitioner's me before the deduction of his salary and 17 percent of Peti- er's gross profit is by itself far from being an inherently cal or even possible indication of unreasonable compensation.

upon the issue as framed by him, - whether there is substan-
evidence to support the Tax Court's finding that reasonable
ensation to Rodgers was $30,000 for each of the years at
e.

While lack of dividends has sometimes been cited in cases
llowing compensation deductions, it is merely a corroborating
ideration used as a supplement to other substantial evidence,
r as a determining factor in and of itself.[4] Unless it would
conomically sensible for a corporation to pay dividends, the
thereof should not be a pertinent consideration even as a
oborating factor. It would have been economic folly for
tioner, with less than $100,000 surplus to have paid a divi-
while embarked upon a new, uncertain venture.

The whole argument of the Commissioner supporting the Tax
t decision is exemplified in the following sentence:

> "To summarize, the overall picture shows increased profits matched by higher salaries -- an indication of the drawing off of corporate profits to controlling stockholders."

tioner agrees that the overall picture certainly does show
easing profits coupled with higher salaries. Why, though,
uch an overall picture an indication of the drawing off of

---

4 As stated by the Court in Bringwald Inc. v. United
es, 334 F.2d 639, 644 (Ct. Cl. 1964), "the mere fact that
rporation has never paid any dividends would not, in and of
lf, justify the conclusion that the salaries paid to an
oyee-stockholder were a distribution of dividend."

rporate profits to controlling stockholders?[5] Increasing
fits are normally coupled with higher salaries, particularly
a case of a small corporation which has paid small compensa-
n during early, formative years.[6] Moreover, Petitioner did
limit its higher compensation only to Rodgers. The compen-
ion of the nonshareholder-employees was subtantially
reased.[7]

The absurdity of $30,000 being the maximum level of
sonable compensation is no more forcibly shown than when this
ure is compared with the compensation paid Rodgers' assistant,
l Everson. Although Everson performed no trading functions
26), Everson earned over $19,800 in salary and bonus for the
cal year ending in 1964 (R 19, Stip. para. 11). The Commis-
ner did not even attempt to claim that this compensation was
easonable. Can it be that the employee of ultimate

---

5 Where the success and earnings of a corporation are
ectly attributable to the hard work, skill, and success of
employee, the reasonable compensation of such employee grows
h the growth of the corporation. See, e.g., Watertown
ttoir Co., 22 CCH Tax Ct. Mem. 258, 268 (1963); Hamilton and
pany, Inc. 18 CCH Tax Ct. Mem. 665, 667 (1959); Schaberg-
trich Hardware Co., 6 CCH Tax Ct. Mem. 269, 275 (1947).

6 As observed by the court in Commercial Iron Works v.
missioner, 166 F.2d 221, 224 (5th Cir. 1948) it is reasonable
iness practice "for an employer to recognize and reward
rifices made by employees in hard, formative days by granting
ore generous compensation in the days that are lush."

7 The compensation for the fiscal year ending in 1964
petitioner's two other principal employees increased by 45.2%
r their compensation in the prior year, while Rodgers'
pensation for the fiscal year ending in 1964 increased by
y 33.8% over the prior year.

ponsibility, the employee who directed Petitioner into a new rse of activity which turned potential financial havoc into r increasing financial success, the employee whose hard work s[illegible]l as a trader had accounted for nearly all of the itioner's net income for the years here in dispute, and the loyee on whom the success of Petitioner is completely endent is worth only $30,000 while his assistant who performs trading functions is admittedly worth over $19,800? Is gers only $10,200 more valuable than Everson to Petitioner?

Both the Tax Court and Commissioner do considerable plaining about the adequacy of Petitioner's evidence. An ropriate answer to such complaint is contained in the follow- statement from Taylor & Co. v. Glenn, 62 F.Supp. 495, 499 D. Ky. 1945) quoted with approval in Mayson Mfg. Co. v. missioner, 178 F.2d 115, 121 (6th Cir. 1949); Baltimore ry Lunch, Inc. v. United States, 231 F.2d 870, 875 (8th Cir. 6); and Robert Louis Stevenson Apts. Inc. v. Commissioner, F.2d 681, 688 (8th Cir. 1964):

> "...If the compensation received...was unreasonable for the services rendered, certainly the government could have produced some experienced witness... who would have said so. The lack of such evidence operates very strongly against the defendant's contention." (emphasis added)

itioner produced the most "comparable" witnesses it could d. They were direct competitors, and understandably declined publicly disclose their exact compensation. Such reluctance uld not relegate their testimony to the category of "little istance" as asserted by the Tax Court. The witnesses knew

compensation of Rodgers in relation to their own, and they uivocally testified that the compensation of Rodgers was arable to theirs. One witness further testified that the ensation paid to Rodgers in view of the Petitioner's net its was not unusual and that he knew of competitors whose ensation was comparable to Rodgers (Tr 45 - 46). What should be expected?[8] In contrast, there is much more Commissioner could have done. To repeat the above pertinent ement, if Rodgers' compensation was really out of line, the issioner could have produced one witness who could have said

Despite the assertions of the Commissioner, the rule of court is that uncontradicted and unimpeached testimony may be disregarded. See Grace Bros. v. Commissioner, 173 F.2d

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8 The fact that much of the testimony was conclusionary due in most part to the Tax Court's own handling of the oral eedings. Having already erroneously prevented Petitioner's ess (David Lees) from testifying as to his opinion of the onableness, counsel for the Petitioner was in a somewhat of andary as to what the court desired to hear. Counsel for Petitioner inquired of the court whether he should not mpt to elicit in greater detail the facts of the comparable- from the witness but the court stated that the testimony as n was enough (Tr 46).

9 A corporate taxpayer must set forth separately on its return the compensation paid to each corporate officer. Commissioner, therefore, has ready access to the compensation rds of a petitioner's competitors. If the Commissioner ot with this available information produce one competitor estify as to his compensation being less than that paid by taxpayer, it is only logical for a strong presumption to e that the compensation paid was reasonable when a competitor testified that his compensation was comparable.

174 (9th Cir. 1949); Anaheim Union Water Co. v. Commissioner, F.2d 253, 260 (9th Cir. 1963). The cases cited by issioner declare only "uncontradicted" testimony need not ollowed if the demeanor of the witness or the improbability he witness' story indicate that the witness' testimony is worthy of belief. See, e.g., Scates v. Isthmian Lines, , 319 F.2d 798, 799 (9th Cir. 1963); Ramos v. Matson ation Company, 316 F.2d 128, 132 (9th Cir. 1963). These s are really saying nothing different than was stated by court in Grace Bros. v. Commissioner, supra at 174:

> "It is axiomatic that uncontradicted testimony must be followed. [Citations] The only exception to the rule occurs when we are dealing with testimony by witnesses who stand impeached and whose testimony is contradicted by the testimony of others or by physical or other facts actually proved or with testimony which is inherently improbable." [10]

In all of the cases cited by the Commissioner, the trial t or hearing officer had specifically found the testimony of witness in question to be unworthy of belief.[11] In the ent case, however, the Tax Court neither expressed nor ied any reservation with regard to the credibility of the imony[12] of either Mr. Lees or Mr. Wiley.[13] Moreover, in all

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10 In essence this Court is saying that uncontradicted imony which is worthy of belief may not be disregarded.

11 The trial court must clearly indicate in its findings the testimony is unworthy of belief. See Ramos v. on Navigation Company, 316 F.2d 128, 132 (9th Cir. 1963).

12 If the testimony had not been creditable, the testi- could not have been of even "limited assistance to the t" (R 82).

13 The testimony being uncontradicted (R 82) and there g no question as to the credibility of the testimony, the Court was bound by the testimony as a matter of law.

cases cited by the Commissioner the fact situation was such
it was quite possible no opposing witnesses were available.
is not the situation in a "reasonable compensation" tax
. As previously observed, the Commissioner can certainly
uce at least one witness if compensation is really
asonable. In the instant case, lack of contradicting
imony raises a strong inference that none of the witnesses
urable through the Commissioner's vast contacts and
urces could have testified that Rodgers was overcompensated
the years at issue.

The Tax Court has given a complete reverse twist to
statement of the court in Taylor & Co. v. Glenn, supra.
er than holding that the Commissioner's failure to produce
tness operates very strongly against him, the Tax Court
arages the witnesses presented by Petitioner although they
the most competent Petitioner could find within its
arative limited sphere of contacts. This stacking of the
against Petitioner was compounded by the Tax Court's
sal to let Mr. Lees express his opinion concerning the worth
odgers.[14]

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14 The authority cited by Commissioner in his attempt to ify the Tax Court's refusal to allow Mr. Lee's opinion not does not support his position but in fact supports a posi- more encompassing than that set forth in Petitioner's ing brief: "Opinion testimony as to reasonableness of ensation is always relevant but its probative value will vary case to case. Obviously, the opinion of an expert is rally more valuable than that of a nonexpert." 4A Mertens, ral Income Taxation, Sec. 25.83 (Rev. Ed. 1966). Thus, not may an expert but also a nonexpert testify.

However, as explained in Petitioner's opening brief, only expertise required of a witness is that he be familiar the particular trade or business in the local area, with taxpayer in his operations, and with the capabilities and

Just as the Commissioner and Tax Court can be heard to
icize the uncontradicted and unimpeached testimony of
esses whose veracity and credibility have not been
tioned, the Commissioner cannot be heard to criticize
tioner's evidence concerning return on invested capital,
icularly where the only ground for objection is alleged lack
omparability.[15] If a return in excess of fifteen per cent
ot remarkable for Petitioner's type of business, the
issioner could have produced contradicting figures since
as access to the rate of return on invested capital for
y taxpaying corporation in the country.

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of the employee whose compensation is in question. Such
rtise, Mr. Lees clearly had. But as seen from the Commission-
cited authority, whether Mr. Lees was an expert or not, his
ion testimony was admissible evidence. The Tax Court was,
efore, required to hear this admissible evidence, and by
sing to do so, the Tax Court was clearly in error. It is
matic that a judge, even when sitting as a trier of fact
hear all evidence of probative value not forbidden by some
ific rule. See I Wigmore, Evidence, Sec. 10 (3rd Ed. 1940);
rd, Sica v. United States, 325 F.2d 831, 836 (9th Cir. 1963).

15 Through the testimony of Mr. Brevig, Petitioner did
blish comparability. Brevig testified that he did accounting
for other local companies that could be considered comparable
etitioner, and that he determined by computation that not
of these other clients had a higher rate of return on invested
tal (Tr 34). He further explained that the local companies
hich he referred were primarily in the trading business like
Petitioner and that trading was at least as large a part of
r business as it was of the Petitioner's business (Tr 35).

*ANY POSSIBLE DOUBT CONCERNING THE REASONABLENESS OF RODGERS' COMPENSATION IS ELIMINATED WHEN UNDERPAYMENTS DURING PRIOR YEARS ARE TAKEN INTO ACCOUNT*

The Commissioner contends that services rendered and com-
sation paid during prior years can be taken into account only
some portion of the compensation for the year of determination
expressly earmarked as compensation for past services,
ferably by a board resolution. All of the cases cited by the
missioner for his earmarking proposition discuss the absence
evidence indicating prior underpayment,[16] with the exception of
. & A.C. Whiting Co., 10 TC 102 (1948). In this latter case
board resolution specifically provided that the bonus was
r services rendered during the present fiscal year." E.B. &
. Whiting Co., supra at 117.[17] In no case has a Court found
or underpayment, but nevertheless declined to take same into
ount merely because there was no earmarking, i.e., no express

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16 "Petitioner corporation further contends that the amount was partly to compensate him for past services rendered during four preceding fiscal years, claiming that in each of those rs his salary was unreasonably low. The short answer is, that re is no factual basis of the record to support this contention." Perlmutter, 44 T.C. 382, 403 (1965), aff'd. 373 F.2d 45 (10th . 1967).

"There is no evidence before us that the officers in stion were underpaid over the previous years..." L. E. Pinkham icine Co. v. Commissioner, 128 F.2d 986, 990 (1st Cir. 1942).

"Conceding that the salaries from 1927 to 1937 were dequate, the record clearly indicates that the corporation made rections therefor prior to the taxable years." Standard estos Mfg. and Insulating Co. v. Commissioner, 276 F.2d 289, (8th Cir. 1960).

17 In this case as well, upon viewing all the facts there ears to be no evidence of underpayment in prior years.

ement that a portion of the compensation for the year of rmination was intended as compensation for prior underpayments. he other hand, the Court took prior underpayments into account out evidence of earmarking in the case of Jewel Ridge Coal s, Inc. 16 CCH Tax Ct. Mem. 140 and Ernest Burwell, Inc. v. ed States, 113 F.Supp. 26 (W.D.S.C. 1953). The rule is ectly stated as follows in Jewel Ridge Coal Sales, Inc., supra 43:

> "...That the services need not be rendered during the taxable year is well settled. It is only necessary that the liability for the compensation be either paid or incurred within the year for which deduction is sought. Lucas v. Ox Fibre Brush Co. 281 U.S. 115 (1930)."

Naturally, a corporation will not earmark compensation for r services unless prior underpayment is believed to exist, so arking may have some evidentiary value in establishing prior rpayment. However, where prior underpayment is otherwise ent and established, lack of earmarking becomes immaterial. ucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930) the issioner on appeal to the Supreme Court embraced the corporate lutions providing that the compensation paid for the year at e was in recognition for prior services. According to the issioner, compensation paid for prior services was not ctible because taxes are determined on an annual basis and ormance of the services, as well as payment for accrual, must r in the same taxable year. The Supreme Court rejected this ention and held that the services need not be rendered during taxable year, it only being necessary that liability for the ensation be either paid or incurred within the year for which

uction is sought. It would represent a gross perversion of as v. Ox Fibre Brush Co. to hold that consideration of prior erpayment in determining the reasonableness of compensation a current year is permitted only when corporate resolutions ressly provide that the compensation is in recognition of or underpayments.

At the beginning of his argument (Br 9) the Commissioner ates that the resolutions of Petitioner's board of directors , for all intents and purposes, expressions of Rodgers' will. iously, it was Rodgers' will that his compensation be uctible in full by Petitioner, so the board of directors uld be deemed to have adopted any and all resolutions which ilitate realization of his will. Why put arbitrary limitations the potency of Rodgers' will? It certainly does not make se for the Commissioner to pooh pooh the significance of porate resolutions in one part of his brief, and then cite k of particular corporate resolutions as grounds for not ing into account obvious prior underpayments which the missioner as much as admits would sustain in full the compensa-on deductions.[16]

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16 There can be no doubt that Rodgers was previously under-d. His aggregate compensation from Petitioner over his nine r period of employment averaged only $22,860.00 per year, le his average annual compensation from his prior employer, ry Warehouse Co., a corporation in which Rodgers owned no ck, was $26,050.00 per year for his management services ch demanded less responsibility, skill and work than his vices for Petitioner.

Nothing is said about earmarking in Treas. Reg. Sec. )4(a)-1(b). As therein unequivocally stated, among the ments to be considered in determining what constitutes a sonable allowance for compensation for services rendered are personal services actually rendered in prior years as well the current year and all compensation and contributions paid or for such employee in prior years as well as in the current r.

The Commissioner contends that the language of Treas. . Sec. 1.404(a)-1(b) does not have applicability to compensa- n deductions under Section 162. This assertion is contrary the introductory sentences of Treas. Reg. Sec. 1.404(a)-1(b) ch reads:

> "(b) In order to be deductible under section 404 (a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a). Contributions may therefore be deducted under section 404(a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered...."

ce a contribution is deductible under Section 404(a) only if is an expense which would be deductible under Section 162 as pensation for personal services actually rendered, anything ring upon deductibility of compensation under Section 404(a) equal applicability to Section 162.

The following sentence of Treas. Reg. Sec. 404(a)-1(b)

ediately precceds the portion of this section quoted in

itioner's brief on page 28:

> "...In no case is a deduction allowable under section 404(a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered..."

underlined portion of the above sentence is identical in

ning to the below underlined quotation from Treas. Reg. Sec.

62-9 entitled "Bonuses to Employees":

> "Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered...."

as. Reg. Sec. 1.162-9 was adopted by the Commissioner after

as. Reg. Sec. 1.404(a)-1. If the provisions of Section

04(a)-1(b) were not meant to apply under Section 1.162-9,

Commissioner would have so stated.

## CONCLUSION

Whether the underpayment of Rodgers in prior years is sidered or not, the Petitioner has presented ample, ontradicted evidence worthy of belief which establishes that compensation paid to Rodgers by Petitioner for the fiscal rs ending in 1963 and 1964 was reasonable. In contrast, the missioner and the Tax Court has pointed to no affirmative dence in support of their determination that $30,000 was the imum level of reasonable compensation for these years. The ision of the Tax Court, being without support in the evidence, clearly erroneous.

For these and other reasons set forth herein and in itioner's opening brief, this Court should reverse the ision of the Tax Court and allow Petitioner a deduction for the compensation paid to Rodgers for the fiscal years ended uary 31, 1963 and January 31, 1964.

Respectfully submitted,

MAUTZ, SOUTHER, SPAULDING
KINSEY & WILLIAMSON

William H. Kinsey SCH

William H. Kinsey

Stephen B. Hill

Stephen B. Hill
12th Floor, Standard Plaza
Portland, Oregon 97204

Of Attorneys for Appellant

CERTIFICATE

I certify that, in connection with the preparation
this brief, I have examined Rules 18 and 19 of The
ted States Court of Appeals for the Ninth Circuit, and
, in my opinion, the foregoing brief is in full compliance
h those rules.

Stephen B. Hill

Stephen B. Hill

Of Attorneys for Appellant